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IMPLICATIONS OF THE IRAN-IRAQ WAR FOR  
PERSIAN GULF OIL SUPPLIES AND PRICING

The attached study, prepared by the Office of Strategic Assessments, International Affairs (DOE), evaluates the impact of the Iran-Iraq War on current and future international oil supply and pricing.

DOE review completed.

Any questions should be directed to John Despres, Director, Office of Strategic Assessments, on 252-8355.

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A CURRENT ASSESSMENT

IMPLICATIONS OF THE IRAN-IRAQ WAR FOR  
PERSIAN GULF OIL SUPPLIES AND PRICING

25X1 The Iran-Iraq war has lasted longer, caused greater damage to oil facilities, and stimulated greater uncertainty about oil prices than most initial estimates suggested. ☐

CURRENT OUTLOOK

For the duration of the war, oil output in the Persian Gulf will be reduced by about 3 MMB/D for most of one quarter, probably two quarters, and possibly much longer. After the war, losses of 1-2 MMB/D for another quarter or two are likely to derive from delays in the repair of facilities and restoration of export capacity. Several outcomes are possible:

Best Case

- Even if the war ends within a few weeks, exports would remain severely depressed in Iraq and Iran for another few months. ☐

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Most Likely Case

- If military operations continue through the winter, as now seems likely, oil exports from the Persian Gulf could probably not achieve pre-war levels until mid-1981. ☐

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Worst Case

- Longer, wider, or more damaging military operations (e.g air strikes against Kuwaiti oil facilities) might reduce Persian Gulf exports by greater amounts. ☐

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25X1 We estimate that cumulative losses of oil supply to the world market are virtually certain to exceed 300 MMB, are likely to exceed 500 MMB, and could even reach 900 MMB within a year. Spot market traders, as well as major producers and consumers, are beginning to anticipate larger supply losses as the war continues. Average world oil prices (including official prices, premiums, and spot market margins) will accordingly rise by at least 10%, probably 15%, and possibly over 20% by the middle of next year, if not sooner. The pace of price increases will depend on US policy choices and OPEC decisionmaking, as well as the following factors: ☐

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- duration of the war, damage to oil facilities, and other constraints on exports;
- offsetting supply increases and demand restraint measures;
- seasonal and cyclical demands that could be unusually heavy this winter and spring in OECD countries; and
- rising expectations of future price increases, which could strengthen incentives to hold stocks. ☐

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IMPACT OF THE WAR

The war between Iraq and Iran will probably continue at least until either Iraq can deny Iran access to Khuzestan's oil or there are leadership changes in Baghdad or Teheran. Both sides are preparing for several more months of war; while the fighting could wind down this winter, it is unlikely to end before next spring or even later. Wet winter weather could impede Iraqi advances more than Iranian defenses. As long as the war continues, total oil output and exports from Iraq and Iran will be constrained by severe damage to loading facilities, active interference with normal operations, and passive security precautions. Gross losses are likely to vary between 3.5 and 4 MMB/D, depending on the scale of both countries' wartime exports. A net loss to the international market of about 3 MMB/D is thus likely to persist, since other Gulf producers will probably not increase output more than 0.8 MMB/D. Unless major repairs are undertaken before the war ends, they could take an additional three to six months. During this time exports through the Gulf, by Iraq in particular, will be far below pre-war levels. Iran could more readily restore its crude oil exports to their low pre-war level, much as Iraq has already resumed exporting through Turkey to the Mediterranean. Assuming alternative dates for the war's end, we have estimated cumulative production losses and their effects on stocks and prices in the Appendices.

PRICING TRENDS

Although spot prices are rising steadily, thus far most buyers have remained publicly calm and refrained from large-scale purchases. The importance of escalating spot market prices has been largely discounted by officials and industry experts, who note that they have comprised less than 2% of total volumes of oil traded. Aggregate supply and demand, rather than limited trading on the spot market, will determine the prices that generally prevail. Moreover, if Iraq can export 0.5-1.0 MMB/D through pipelines to the Mediterranean, upward pressure on these prices could be largely relieved.

However, with heavier demands for winter heating supplies and a recent warning by Saudi Oil Minister Yamani that the world may be on the verge of a new round of panic oil buying which could drive up contract prices even before mid-December, desperate buyers may attempt to secure available supplies at higher prices. Spot prices, notwithstanding limited volumes, have repeatedly been used by producers to justify contract price increases. Kuwait recently sold contract oil to a Japanese company with a premium that closely followed spot market trends. Japanese companies could well be the first to abandon the restraint generally exercised thus far. One trader has suggested that in a few weeks MITI will succumb to growing restiveness on the part of Japanese industry and allow much higher purchase prices. Persistent expectations of excess demand, uncertainty about the duration and extent of the war, and a reluctance to deplete existing stocks could compound demand and restrict supply to the world oil market. Particularly if buyers panic, producers may seek to impose higher contract prices and premiums on their long-term customers. Failing this, producers could divert larger volumes to the more profitable spot market.

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MULTILATERAL OPTIONS

Attempts to spread shortages more evenly through sharing arrangements in the IEA, domestic oil reallocation, or other mechanisms could temporarily dampen competitive bidding for limited supplies on the spot market. Without any action, in the best plausible case, world oil prices are likely to rise by at least \$3 per barrel by the middle of 1981. But prices are more likely to rise by \$5 per barrel unless the war ends soon or a strong program of countermeasures is undertaken. Prices might rise as much as \$8, \$10, or by even larger increments per barrel if a more widely destructive war, a harsh winter, or other adverse developments were not offset by new multilateral restraints on oil demand. [ ]

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Barring the rapid restoration of normal export operations in Iran, Iraq, and the Persian Gulf, a multilateral program would be needed to prevent most of the price increase due to a much more damaging war. The United States would have to lead the way by adopting a variety of moderately stimulating energy supply-enhancement, fuel-switching, and oil demand-restraint measures. This could provide the basis for a coordinated contingency plan to impose import fees, quotas, or other restraints on demand to pre-empt producer price increases and minimize the economic losses of consumer economies. [ ]

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Under the formula that OPEC's Long-Term Strategy Committee Chairman Yamani has proposed and begun to implement unilaterally in Saudi pricing policy, price increases of \$1-2/b would be due each quarter. So, benchmark and average crude prices are almost certain to increase \$3/b within the next six months unless OECD growth and inflation rates abate. By the middle of 1981, the Iran-Iraq war could raise world oil prices by another \$2-5/b. The size of this additional increase will depend on the actual course and effects of the war as well as other strategic, economic, and psychological factors. Several possible outcomes can be distinguished:

- Best Case - Aggregate production loss will be 300-500 million barrels. Average prices (FOB) will rise about 10% above the current \$32/b OPEC price to around \$35/b.
- Most Likely Outcome - Aggregate production loss will be 500-750 million barrels. Average prices will rise about 15% to around \$37/b.
- Worst Case - Aggregate production loss will be 750 million to 1 billion barrels. Average prices will rise 25-30% to \$40-42/b.

The assumptions underlying these outcomes are as follows:

- Best Case - Presumes that winter weather in OECD countries will not be severe; that the war ends by the turn of the year; that the conflict is at least apparently settled and there is a vigorous recovery and reconstruction program for damaged Iraqi facilities; that Iraqi pipeline exports return immediately to about 1 mmb/d; that special loading devices are installed within two or three months as an interim substitute for the damaged sea island terminals; that these terminals are repaired so that exports are back to normal within 6-9 months; that security is restored within Iran and Iranian exports pick up within a month or two; and finally that these developments are well known by late January 1981. (This last condition is critical because final decisions on contract prices for the first quarter of 1981 cannot be deferred beyond mid-February. These prices will be determined by the parties' current expectations of future supply and demand.)
- Most Likely Outcome - Presumes that the war continues at least through January; that there is additional damage to both sides' export capacity; that the recovery period takes longer than in the Best Case; and that the end of the war and restoration of production will not be clearly foreseeable prior to first quarter contract decisions and perhaps not until after mid-May when prices for the second quarter will be finally fixed.
- Worst Case - Presumes the same facts as in the second case plus additional constraints on Kuwait's exports, an extremely harsh winter, rapid economic expansion, and other developments which cut supply or raise demand more than expected.

In all cases, other Persian Gulf producers are presumed to keep their output about 0.7 MMB/d above pre-war levels until Iran and Iraq approach their pre-war levels. (Contrary to published information, Kuwait has not sustained production increases and has imposed security constraints on its oil export operations. Also contrary to presumably well-informed opinion, Saudi Arabia has been unable, for technical reasons, to sustain production increases above 10 MMB/D.)

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APPENDIX 1

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EFFECT OF THE IRAN-IRAQ WAR ON OIL STOCKS AND PRICES

Alternative Out- come of the Iran-Iraq War	Projected Month of War's End	Cumulative Oil Output Losses (MMB)	"Excess" Draw- down <u>1/</u> (MMB)	Average Consump- tion Cut Needed to Re-stock by mid-1982 <u>2/</u> (MBD)	Nominal (Real) Price Increase Needed by mid-1981 to Restore Normal Stocks in 1982 <u>3/</u>	% Official Price Increase Implied	Project Official Price o 7/1/81 <sup>4</sup>
Best	Dec. 1980	300	0	0	\$2 (\$0)	6½	\$34
Better	Jan. 1981	450	150	400	\$4 (\$2)	13	\$36
Likely	Mar. 1981	600	300	800	\$6 (\$4)	19	\$38
Worse	May 1981	750	450	1200	\$8 (\$6)	25	\$40
Worst	July 1981	900	600	1600	\$10 (\$8)	31	\$42

1/ Assumes that current "excess" stocks worldwide are 300 MMB and that an additional 600 MMB of "normal" stocks could also be drawn down.

2/ Re-stocking is assumed to take place within about a year of war termination.

3/ Assumes the short-term price elasticity of world demand for oil is -.15.

4/ Official price for Arab Light, which is assumed to approximate the average price for all oils.

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Persian Gulf Oil Supplies and Pricing

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